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Tax Primer for United States Investment in Canadian Business, A

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A Tax Primer for United States Investment in Canadian Business

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I. Introduction

United States Investment in Canada can take two alternative forms. The first form is that of a sole investor. The sole investor can invest as either a branch of a U.S. corporation or as a new Canadian corporation.

Investing in a branch of a U.S. corporation permits the consolidation of the Canadian result with the U.S. results for U.S. tax purposes. A desirable tax result can be obtained if the new Canadian investment is a high risk investment and likely to generate losses. These losses could be offset against income in the United States. However, two substantial limitations apply. First, the U.S. overall loss rules apply. These rules permit the recognition of losses on a current basis, but impose a requirement of recapture when profits are generated from foreign sources.[1] For U.S. enterprises with other profitable foreign operations this may pose no problem. However, losses from the new venture when taken together with allocations required in connection with the new venture may create foreign tax credit limitation problems for the U.S. investor.

Secondly, if the Canadian business is a new trade or business for the "taxpayer," then the start-up losses may not be deductible.[2] Even so the investor may elect to recover such start-up costs over a six year period.[3]

In this regard it is worthwhile to note that not all initial costs are "start-up" costs. Nonetheless a serious problem may arise because home office to branch charges will constitute tax events for Canadian purposes (for the most part deductions). These will be eliminated in the corporate books on a consolidation basis. As a result, strong disparaties between Canadian and U.S. tax books may arise that reflect a very high effective tax rate in Canada. Moreover, Canadian withholding taxes may apply where there is no income from a U.S. tax viewpoint giving rise to a potential for lost foreign tax credits. Once again this is a more substantial issue for the enterprise just beginning foreign investment than it is for the es-

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[1] Special rules apply to oil and gas operations. *See* I.R.C. § 907(c)(4) (1984).

[2] Richmond Television Corp. v. United States, 345 F.2d 901 (4th Cir. 1965).

[3] I.R.C. § 195(a) (1984).

tablished multinational. Even so, an established multinational may be so firmly within foreign tax credit limitation that this issue will be substantial.

The consolidation result that may produce a benefit when the branch is new results in the current taxation of Canadian income upon its generation without regard to transborder cash flows. For a service or labor intensive business this may not be a major problem since the tax rates between the United States and Canada are not significantly different. For capital intensive businesses this factor of current taxation alone will probably make the branch unattractive. Canada permits a substantially more rapid rate of capital cost recovery than does the United States for non-U.S. assets.[4] As a result the business would have U.S. taxable income where there was no Canadian taxable income. The potential for juridical double taxation that exists in this area is serious.

Canada imposes a tax on the profits of a branch that operates in Canada in lieu of the withholding tax on dividends.[5] Thus, for profitable operations there are two elements of current taxation imposed on a branch that do not affect a Canadian corporation: 1) current U.S. income taxation; and 2) branch-deemed distribution taxes. These may affect, in a damaging fashion, the growth and cash position of the Canadian business.

Incorporation of the branch once the business becomes profitable is not free from problems. The Internal Revenue Service (IRS) is inclined to challenge such transfers as being taxable events.[6] Revenue Canada may impose rules on the transfer of assets that create a disparity between the basis in the new corporation's stock for Canadian and U.S. tax purposes that could expose the U.S. shareholder to substantial Canadian taxes upon disposition of those shares. Because of the differences in capital cost recovery rates it is almost certain that there will be differences in the carry-over basis for the new stock for U.S. and Canadian tax purposes. Apart from the branch tax there does not seem to be a penalty on branch operations.

As an alternative to investing as a U.S. branch, a Canadian corporation can be formed to conduct Canadian business. It will insulate the operating results from U.S. income taxation. As a result, no losses will be usable against U.S. source income. The exception to this rule would be a corporation that meets the qualifications of Internal Revenue Code (I.R.C.) § 1504(d). That provision permits the treatment of a Canadian corporation as a U.S. corporation for purposes of U.S. tax consolidation if

[4] Canadian Tax Act Reg. Part XI and Schedule II (1983).

[5] Income Tax Act ch. 63, § 219 (Part XIV), Can. Stat. 1970-71-72 (1983). Tax is levied on the Canadian taxes paid plus or minus other special adjustments related to dividend income, resource allowance, capital gains and losses, etc. *See* IT 137 (Canadian). This is 25% reduced to 15% by Canada-U.S. Treaty.

[6] Rev. Rul. 78-201, 1978-1 C.B. 91. Legislation is pending to block such tax free transactions. Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 122, 98 Stat. 494, 643-44.

a Canadian corporate form is necessary for the conduct of the business or to own the property of the business. The consequences of an I.R.C. § 1504(d) corporation are somewhat different than the branch of a U.S. corporation. Because this form is relatively rare this discourse will not discuss it further.

As a non-consolidated corporate entity the profits will not ordinarily be subjected to U.S. taxation until the profits are distributed as dividends to the U.S. shareholder.[7] It is important that the Canadian corporation owned by a U.S. shareholder not make investments in the broad class of property defined as "U.S. property" by I.R.C. § 956(b). Such investments can result in deemed distributions to the U.S. shareholder. These rules can provide a significant trap for the unwary and also provide a planning tool for the thoughtful planner.

Certainly the Canadian corporate form is likely to produce a generally forecastable result for the investor since its advisors will be dealing in a format with which they are more familiar. There must be careful balancing of the potentials for tax saving against the more conventional locally incorporated format.

Joint investments with two or more co-investors present a similar decisional pattern to the branch versus Canadian corporation. In the joint operation situation the choice is between an incorporated venture and a partnership.

A partnership from the U.S. investors' viewpoint presents some interesting opportunities. The operating results from a partnership flow directly to the partners under U.S. tax law. That is so even if the partnership is a foreign partnership. In a partnership the partners may make special allocations of items of income, deductions, credits, gains, or losses as long as such allocations reflect "economic substance" and are not merely tax avoidance devices.[8]

Canada also applies a conduit theory to the treatment of partnerships. However, special allocations of the sort permitted under U.S. law are not allowed. As a result disparaties would develop in the accounting for income and capital between Canadian and U.S. joint ventures operating in a partnership format. First, a partnership will be considered a nonresident person for Canadian tax purposes if any of the partners are not Canadian residents. This will give rise to withholding tax problems if the partnership receives payments from Canadian residents subject to withholding taxes.

This may also give rise to further consequences where services are provided by a Canadian resident partner to the partnership. While there might be a technical issue if all parties including the partnerships were residents, the tax authorities might overlook it when all events remain in

[7] If the Canadian corporation generates non-Canadian source income or substantial passive income Subpart F, it may give rise to current U.S. tax incidence.

[8] I.R.C. § 704(b)(2) (1984).

Canada. Or, if it were raised, the economic consequences may be *de minimus*, but with the withholding issue involved the problem is likely to be highlighted. However, this problem may be less significant than it would otherwise seem because Revenue Canada permits resident partners to credit withholding taxes paid against the partners' tax liability.[9]

There would also be direct differences between the rates of capital recovery and other items for the partners. However, that might not necessarily adversely affect the relationship of the partners or the business itself. The U.S. partner would not, simply because of its investment in the venture, be treated as a Canadian resident for Canadian tax purposes. A U.S. partner would, however, have a permanent establishment in Canada and would be taxable on the partnership's income.

Transactions between a partner, acting in a capacity other than as a partner, and the partnership are not eliminated on a consolidation basis as they are in a branch situation since the problems created by the consolidated U.S. tax return do not plague the partnership. Therefore, once more the critical decision of losses in the early years versus deferral of U.S. taxation of long term profits becomes the economic determinant for the U.S. investor.

The corporate form from a U.S. shareholder's viewpoint does provide the insulation from the incidence of U.S. taxation except where dividends are paid. In addition, a corporate joint venture in which U.S. persons own 50 percent or less of the equity is not a "controlled foreign corporation," with major differences in reporting requirements and exposure to the provisions of Subpart F.[10]

A Canadian corporation formed after April 16, 1965 is deemed to be a Canadian resident.[11] It is thus subject to taxation in Canada on its worldwide income. It is de facto a Canadian withholding agent for payments to nonresidents which are subject to withholding taxes.

Certain long term debt arrangements between unrelated foreign persons and nonresidents may be exempt from withholding taxes. A U.S. shareholder will still have differences between earnings and profits calculated for U.S. tax purposes, and the earnings and profits determined for Canadian tax purposes.[12] In addition, if the corporation is not a controlled foreign corporation a yet different method of earnings and profits calculation may be imposed.[13] These calculations are important because of the calculation of the amount of foreign tax credit allowed a U.S. shareholder under I.R.C. § 902, or § 960, and for purposes of determining.

[9] IT - 8 IR (Canadian).

[10] I.R.C. § 957 (1984). The definitions of U.S. person, and controlled foreign corporation are statutory creatures and need special review by potential investors. Those questions are beyond the scope of this discourse.

[11] Income Tax Act, § 250(4) Can. Stat. 1970-71-72 (1983).

[12] Treas. Reg. § 1.964-1 (P-H Federal Taxes Vol. 7 1984).

[13] I.R.C. § 902 (1984), Treas. Reg. § 1.902-1(e)-(g) (P-H Federal Taxes Vol. 7 1984).

the nature of distributions in respect of shares.

II. Structural Issues

Whether the operation is a corporation or partnership, issues arise as to the entity's structure. Because of the conduit nature of a partnership, the structural factors tend to be less significant. However, the issues attendant to loans between residents and nonresidents deserve attention.

Debt to equity questions are important under both U.S. and Canadian tax law. The issue centers around whether the equity capital is adequate in proportion to the debt. Because interest payments are deductible, while dividend payments are not, the tendency is to weight the structure with a preponderance of debt. For U.S. purposes this factor is exacerbated by the fact that dividend distributions paid when earnings and profits exist are taxable income while principal repayments do not attract Canadian withholding taxes.

For Canadian purposes interest payments to nonresident shareholders who own as much as 25 percent of any class of the corporation's stock may be non-deductible to the payor resident corporation.[14] The effect of such treatment is to create a dividend out of interest payments. Across the border such amounts will probably not be treated as a dividend. This means no adjustment to earnings and profits will occur, no deemed paid foreign tax credit will be allowed on the Canadian corporation's earnings, and credit might be denied for the withholding taxes imposed on the "dividend," since for U.S. purposes the payment may still be a repayment of principal.

For U.S. purposes, what constitutes capitalization is less clear. The matter has been a judicially determined question and, recently, regulations have been considered in the U.S. that would have governed debt to equity ratios.[15] Those proposed regulations dealt not only with the debt to equity issue but also would have reclassified debt and equity instruments with a result of creating numerous tax planning opportunities sanctioned by rather inflexible regulations.

Because of the Canadian rules and their interplay with the U.S. foreign tax credit provisions, it is important to be certain that what is established as debt remains such after its issuance. Avoidance of a debt to equity ratio in excess of 3:1 is important. Attention must be given to recapitalization situations to avoid double counting of old and new debt that might violate the rules. Odd instruments intended as equity but which are too close to debt could also create problems.

A second issue is that of stock. Assets contributed in exchange for common stock, the standard stock classification, will not ordinarily create income under the tax laws of either the United States or Canada. For

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[14] Income Tax Act § 18(4)-18(f) Can. Stat. 1970-71-72 (1983).

[15] Proposed Treas. Reg. § 1.385-1 (withdrawn effective August 5, 1983).

U.S. purposes, the transaction will carry over the adjusted tax basis in the asset to the stock. Canada normally accords the same treatment for assets exchanged for shares.

An advance ruling may be necessary for the outbound transfer of assets into a foreign corporation.[16] Specific rules are contained in the regulations for obtaining rulings in respect of such transfers. Also, at the time of this writing, legislation is under consideration in the United States that would ban tax free transfers of technology.[17]

Acquisition of stock in a Canadian corporation creates no tax issues, but provides no tax benefit to the acquirer in respect of any premium paid for the shares. This encourages asset acquisitions to be followed by their contribution to a corporation to obtain a step-up to the fair market value of the assets.

The Canadian seller of the assets has tax consequences which are governed by Section 20 of Canada's Income Tax Act (the Act). If the seller sells all of the assets of the business the tax consequence would be immediate with recapture of previously claimed capital cost allowances at ordinary income tax rates. If the sale is of less than the entire business then the proceeds attributable to depreciable property are charged against the asset pools. This produces a deferred recapture by denial of future capital cost allowances.

Sometimes it is intended at the outset that one joint venturer is to have a benefit distinct from those equally shared by the other venturer(s). There are at least two commonly used devices to accomplish this effect. First, redeemable preferred stock can provide a special sharing of profit to compensate for a special contribution at the commencement of business. The dividend on the preferred can compensate for the use of the special item until the item is "paid for" by way of redemption. The redemption has the effect of repaying the capital value of the special item.

Assignment of value to the redeemable preferred shares is important from a tax viewpoint. Shares in the hands of a nonresident are taxable Canadian property. Thus redemption of the shares at a price higher than the tax adjusted basis will create a taxable Canadian gain. Such distribution is likely to be treated as a dividend with withholding tax consequences. Also, if value can be reasonably assigned to the shares to be redeemed at or near the redemption price, tax on the redemption can be minimized.

If there is to be gain on the redemption the shareholder should make every attempt to have the same basis applied for both U.S. and Canadian tax purposes. U.S. taxation will also occur on redemption. Canadian taxes paid in the course of the redemption should serve to reduce the U.S. taxes payable on such redemption on a dollar-for-dollar basis.

In some circumstances distributions in respect of preferred stocks

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[16] I.R.C. § 367(a) (1984).

[17] Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 122, 98 Stat. 494.

may be treated as dividends for U.S. income tax purposes, and thus fully taxable. While an analysis of this situation is beyond the scope of the discourse, it is worthwhile to observe,[18] a planning opportunity exists for redemptions when earnings and profits from a U.S. tax viewpoint are non-existent, or when the U.S. shareholder is already in U.S. foreign tax credit limitation.

If a partnership format is used for the joint venture, special distributions can be made under the partnership agreement. Special allocations may also be made that would permit such disproportionate distributions.[19] Section 103 of the Act also permits disproportional distributions, but they are prohibited if the prime reason for them is reduction or postponement of taxes otherwise due.

III. Intercompany Issues

Intercompany issues are the source of ongoing problems for the transborder investor. Establishing a proper treatment of intercompany items at the outset is of vital importance. Bad initial planning can lead to suprises later that have potential to provide disastrous effects on the venture. Creation of a mold acceptable to the investor is always better than having the revenue authorities make those decisions for the investor on an after-the-fact basis.

All transactions between the U.S. resident investor and the investment vehicle are suspect and subject to challenge. Section 251(1)(a) of the Act presumes related parties do not deal with each other at arm's length. Those who do not deal with each other at arm's length are subject to provisions which permit Revenue Canada to adjust intercompany items to "fair market value."[20] Such adjustments may affect only one taxpayer with a resultant double taxation of the same economic income.

Under I.R.C. § 482 the IRS may act to restate items to reflect an arm's length treatment among controlled taxpayers. Control for this purpose seems to extend at least to a 50 percent shareholder.[21] Regulations implementing § 482 are very detailed and endeavor to deal with a broad variety of transactions.

Moreover, case law in the United States requires correlative adjustments to each of the related parties involved in the non-arm's length transaction.[22]

However, even if the IRS grants the correlative adjustment, that will not affect the income as originally stated for Canadian tax purposes. Usu-

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[18] For comment on this subject see B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders paras. 10.04, 7.62.4 (4th ed. 1979).

[19] I.R.C. § 704 (1984).

[20] Income Tax Act § 69(1)(a) Can. Stat. 1970-71-72 (1983).

[21] B. Forman Co. v. Commissioner, 453 F.2d 1144 (2d Cir. 1972), *cert. denied*, 407 U.S. 934 (1972).

[22] Smith Bridgeman & Co. v. Commissioner, 16 T.C. 287 (1951).

ally an adjustment from the IRS would increase the U.S. shareholder's tax liability and this will almost certainly result in juridical double taxation unless relief is obtained. This could be accomplished through timely amendment of the Canadian tax return for the year in question or by application for competent authority relief. Neither course of action is free of problems.

Careful documentation of the intercorporate items is extremely important. Ambiguous, unclear intercorporate agreements are apt to lead to suspicion from tax authorities on both sides of the border, with all inferences construed against the taxpayer. On the other hand, unambiguous documents are superior evidence in any proceeding. Of course, written agreements do limit the taxpayer's flexibility, but such flexibility is limited through the authorities' power to adjust intercompany items in any event.

Drafting the document forces the planner to think through the results of the agreement with the consequence of fewer unpleasant suprises at a later date. Relief clauses for adjustment on the Canadian side deserve careful thought. Such clauses may create suspicions about agreements where none are warranted. On the other hand, with no right to correlative adjustment a taxpayer could be badly hurt by successful adjustment if no adjustment clause exists.

A very sensitive area, particularly from a Canadian viewpoint, is management fees. The draft informational circular on Transfer Pricing and Other International Transactions would categorize central management expense as:

a. expenses of the parent company in its "custodial" capacity, i.e., as a shareholder managing its investments in subsidiaries;

b. expenses that are clearly incurred for the benefit of a single company in the group; and

c. expenses that are incurred for the benefit of a number of companies or the group as a whole.

The draft raises serious questions concerning the last of the three categories. It also raises a question as to the appropriateness of the allocation where the Canadian company is fully staffed to provide its own management functions. It would disallow duplicative functions from abroad. Also, the draft circular explicitly comments on the risk of juridical double taxation where services are duplicated. Another consideration are those payments which attract withholding taxes and those which do not. The latter category is for those services which are specifically rendered to the benefit of the Canadian taxpayer. Such items may be billed at cost, i.e., no mark-up and, if mark-up is billed, it is subject to withholding. Indirect costs associated with such items would be treated as subject to withholding. Specific items must be identified and invoiced at the time of rendition.

Items which are not an item specifically rendered for the Canadian taxpayer's benefit will be analyzed for their benefit to the Canadian taxpayer. General charges based on a percent of sales, flat rates or similar arbitrary method would no longer be acceptable. Therefore, the basis for the charge must be established in advance.

From the U.S. side, management fees are subject to § 482 allocations.[23] Such allocations may be made on the basis of time spent on a weighted salary basis, or by other relevant measuring devices. Whether this is a general allocation violative of the draft information circular is not clear. However, careful preparation of the agreement should result in compliance with the requirements of both sets of revenue authorities.

What constitutes a management service has at least been partially defined in *Young & Rubicam v. United States.*[24] This case ruled that where the effort of the U.S. parent goes to the conduct of the local subsidiary's business, the effort is a management effort and subject to intercompany charge. If the effort is directed to the parent's business, for instance, furthering of sales by the parent into Canada, or the effort is directed to stewardship over the Canadian investment, then the amounts are not management charges subject to allocation under § 482.

The U.S. rules require an allocation of U.S. incurred expenses to foreign source income.[25] Such allocations affect only the sourcing rules attendant to foreign source income and do *not* affect the income of the foreign entity itself. Charging such allocated items to the foreign entity does not eliminate the need to make allocations. Indeed, it would probably be improper to charge the Canadian company with stewardship expenses. The amount charged would only reduce the amount which remains to be allocated and the allocation would still be made on the same proportionate amount of the remaining expenses. Technology and research and development charges are so closely linked that they must be discussed together. Whatever technology is required by the new Canadian venture of a U.S.-based investor may be transferred to the Canadian company. If a favorable ruling is obtained from the IRS that item may be transferred free of U.S. tax. Furthermore, the items transferred tax free must constitute "property," which means basically they must be the whole Canadian property right in the technology. Also, if the transfer is made to a partnership, a favorable *advance* ruling must be obtained under I.R.C. § 1492. Failure to obtain an advance ruling subjects the transfer not only to taxation but to a penalty excise tax.

Other ways in which to transfer technology to the company would be to use a license bearing a running royalty or transfer for a flat price. However, a transfer for a flat price is not very attractive economically. The transferer would put money into the venture proportional to its equity position followed by a taxable transfer back to itself. The primary beneficiaries of that transaction are the tax authorities. Making the transaction

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[23] Treas. Reg. § 1.482-2(b) (P-H Federal Taxes Vol. 5 1984).
[24] Young & Rubicam, Inc. v. United States, 410 F.2d 1233 (Ct. Cl. 1969).
[25] Treas. Reg. § 1.861-8 (P-H Federal Taxes Vol. 7 1984).

even less attractive is the fact the U.S. would tax the transaction at ordinary income tax rates.[26]

A running royalty would be a deductible expense to the Canadian corporation. Canadian withholding tax would be exigible on the payment, but even so the payment would be one of low taxed foreign source income. Such payments are at least neutral from a U.S. tax viewpoint, and low taxed foreign source income is attractive to a U.S. taxpayer approaching or in foreign tax credit limitation.

From the Canadian viewpoint the acquisition of the entire property right would be a nondeductible capital expenditure. One-half of such cost is recoverable as an eligible capital expenditure. Care should be taken, if the technology is to move for cash, that property is not transferred to preserve the deduction. If this cannot be done then the technology transferred should be tied to a Canadian patent. If that is done then at least the value should be recoverable over the outstanding life of the patent.

No safe haven value for royalties is available on the Canadian side. A limited exception to this arises in respect of pharmaceutical items. The draft information circular provides criteria for evaluating the royalty.

Closely related to the licensing of technology is the question of charges for ongoing research in the U.S. parent. To the extent central research is made available to non-U.S. subsidiaries by way of licenses bearing royalties, there does not seem to be much room for a charge for research and development (R&D) expense. Conversely, if a Canadian subsidiary pays a continuing charge for R&D expenses it should have a royalty free access to the technology generated by the research.

Perhaps the entry of a cost sharing arrangement is a satisfactory way of dealing with the case where the U.S. parent wishes contribution to its R&D effort by non-U.S. subsidiaries. This method can obtain the sanction of both revenue authorities if the method of cost sharing is reasonable. However, it foregoes the opportunity for low taxed foreign source income. An aspect of this issue that should not go unnoted is the possibility of doing research in Canada and selling it back to the U.S. parent. This can provide some cash savings in the right situations. It can also help the U.S. parent earn additional low taxed foreign source income.

Charges for the use of money are another area of transborder concern. Earlier, this discourse addressed the issue of structure and the role of debt in the structure. Loans from nonresident members of the group of which the Canadian company is a member are subject to examination to judge the arm's length nature of the terms. In addition, the terms, apart from the interest rate, are relevant in setting the interest rate.

Critical to treatment of debt as debt is the taxpayers' observance of the debtor-creditor relationship in handling the debt. Terms reflecting those of an unrelated lender must be observed. Failure to do so may re-

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[26] I.R.C. § 1249(a) (1984).

sult in the treatment of the "debt" as a hidden capital contribution.

For U.S. purposes safe haven interest rates may be useful. These rates have tended to provide an opportunity to charge a bit less than the full market rate. On that basis, Revenue Canada would probably not complain since it provides a smaller deduction in Canada. However, Revenue Canada might raise this issue if its intent was to attack the nature of the underlying transaction.

Guarantees of debt by U.S. parents, whose subsidiaries owe third parties, can be a difficult issue. The IRS has endeavored to make this an issue for some time, but found it difficult to get a clearly advantageous situation. The thrust of the issue is whether the parent guaranteeing the debt of its subsidiary should be compensated for the guarantee. In recent years a loan from the United States to a subsidiary might actually be less advantageous to the fisc than a local borrowing guaranteed by the parent. In some cases a local corporation may be entitled to lower cost debt than a foreign borrower and, thus, the worldwide enterprise including the parent benefits from the borrowing in local markets. Who, then, is benefited by the local transaction?

If the parent must make good the guarantee then a three-cornered transaction may occur. Payment of interest to a Canadian lender would give rise to U.S. withholding on the interest portion. The parent then would be treated as either having made a capital contribution to the subsidiary of the amount paid or as having a debt owing from the subsidiary upon which the IRS might impute interest.

Sales of goods between the U.S. and Canadian companies present an area of concern that is omnipresent. Both the IRS and Revenue Canada seem inclined to use the same criteria for judging intercompany pricing of products. These criteria are presented in the order of acceptability:

a. unrelated comparable price;
b. resale price method;
c. cost plus method;
d. other methods.

Despite "other methods" being the least acceptable in the sequence, one suspects that very many settlements include at least some part of the method as not part of the first three.

Completely comparable situations are very hard to find so that method is not used very often. Also, transfers from the United States to Canada are much more complicated by the presence of the Domestic International Sales Corporation (DISC) in the midst of the transaction. From a theoretical point of view, the price, if a resale price method is used, should stand if the discount is reasonable for similar goods. Being forced to "a fourth method" could bring on an unfavorable result because a functional analysis of the DISC's contribution might not be very favorable. A substantive DISC that makes its own contribution to the transaction should receive more favorable treatment.

Taxpayers have been caught in the pricing conflict between the customs and revenue authorities. Until now there was little correlation between the values established for customs and tax purposes. Customs legislation under consideration would purport to use an "arm's length" principle. Even so, one might wonder if the conflicting goals of customs authorities and those administering a net income structure will cause substantial differences in the government's perception of arm's length.

A better bulwark from the taxpayer's viewpoint might be a consistent policy where transfers of goods reach both ways across the border. Obviously an unreasonable method could reach both ways. However, if the taxpayer is satisfied he would take either argument with equal ease, the intercompany pricing system may well be sound.

Whatever the intercorporate pricing issue, the taxpayer is likely to receive a better result if three rules are followed. First, the method should be established in a written document. The act of writing the document is likely to clarify the questionable issues in the system. Also, there is greater likelihood that those implementing a written program will understand it. Finally, although the document may be self-serving at least it establishes a practice, as opposed to trying to justify a non-policy *nunc pro tunc*. The revenue authorities have to argue that they know more of what makes sound practice than those in the business.

The second rule is that the practice should be followed in light of favorable and unfavorable fact situations. The immediate temptation is to run from the agreed intercompany practice if it takes a bad turn. Obviously, if the agreement cannot be sustained as a long term business practice it may have to be abandoned. However, if the problem is only an aberration caused by unusual facts, the best proof a taxpayer may have is to stick with the established practice.

The third rule is to insure that established theory is implemented as planned. Many of the tax cases lost in the U.S. intercompany transaction area are lost because a sound plan is not followed. As such, following up the tax plan to be certain the agreed policy is implemented is essential.

IV. When the Taxman Comes

The first action to account to the tax authorities is to marshall the documentation of the planned intercompany policies. This provides an opportunity to focus the discussion. Plans established within the meanings of the regulations are dependable.

The taxpayer may wonder if he, she or it can rely on "competent authority." In many cases the taxpayer is merely a stockholder. By attempting to invoke withholding taxes in the course of disputes, revenue authorities have been known to attempt to blunt the approach to competent authority.

Not all cases are susceptible of favorable resolution by competent authority. Competent authority resolution takes time. If the questioned item is continuing it can result in a large buildup of potential liability during the resolution process.

Situations not susceptible of competent authority relief are generated when the adjustment by one taxing authority does not necessarily leave a correlative effect across the border. Particularly sensitive to this are situations where the amount of the item is left unaltered but the item is reclassified, e.g., change of an interest payment to dividend by the Canadian authorities. Withholding tax would still be due, the amount would still be fully taxable in the U.S. with no deemed paid foreign tax credit, no deduction would be allowed to the Canadian entity for the payment, and earnings and profits would not be altered for U.S. tax purposes. No treaty or competent authority would apply if the adjustment to the Canadian corporation were based on Canadian law applicable to the corporation irrespective of its transborder owner.

Issues involving the timing of recognition of items probably do not give rise to a competent authority matter.

Interauthority information exchanges and joint audits lessen the likelihood that a matter will not be fully understood by the tax authorities. No longer can a taxpayer in one country deny the authorities in another access to data upon which an adjustment might be predicated with any security that the questioning authority is thereby thwarted. Under U.S. law, refusal to provide information on the grounds of unavoidability may bar the introduction of helpful information obtained from abroad as evidence in fighting an arbitrary assessment.[27] Joint audits permit focus on specific issues of mutual interest to each of the respective tax authorities.

V. Conclusion

Thoughtful tax preparation of the new U.S. investment in Canada is important in establishing the economic soundness of that venture. This takes the tax planner past the initial structuring of the venture. Proper documentation of the anticipated operating situations is important. Therefore, a taxpayer should do several things:

1. Get intercompany agreements in place at the outset;
2. Consider future financing opportunities from the start;
3. Plan cash flow in both directions;
4. Decide what U.S. management will be needed and how to pay for it; and,
5. Look at economic assumptions adopted by planners with skepticism, asking what may go wrong and how will such occurrences affect the tax plan.

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[27] I.R.C. § 982(a) (1984).